86-1247

No.

Supreme Court, U.S.
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JOSEPH F. SPANIOL, JR.
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

LILLIAN K. SHENKER,

Petitioner,

VS.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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QUESTION PRESENTED FOR REVIEW

I. Whether the Tax Court erred in holding that, as a matter of law, claims of deduction by Petitioner's husband on a joint return for expenses incurred by other persons on property not owned by him are claims in an amount having a valid basis in fact or law, such that Petitioner was not entitled to present evidence of her right to relief as an innocent spouse.

26 U.S.C. Section 6013(e);

National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949).

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2A Sutherland, *Statutory Construction,* (4th ed.) pp. 33, 132 15

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OPINIONS BELOW

The Memorandum Findings of Fact and Opinion of the Tax Court (Pet. App. A-1) are not officially reported. The opinion of the Court of Appeals (Pet. App. A-27) is reported at 804 F.2d 109 (8th Cir. 1986).

JURISDICTION

The judgment of the Court of Appeals was entered on October 27, 1986. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. Section 1254(1).

STATUTORY PROVISIONS INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 6013. JOINT RETURNS OF INCOME TAX BY HUSBAND AND WIFE.

(e) Spouse Relieved of Liability in Certain Cases. —

(1) IN GENERAL. — under regulations prescribed by the Secretary, if —

(A) a joint return has been made under this section for a taxable year,

(B) on such return there is a substantial understatement of tax attributable to grossly erroneous items of one spouse,

(C) the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such substantial understatement, and

(D) taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such substantial understatement,

then the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such substantial understatement.

(2) GROSSLY ERRONEOUS ITEMS. — For purposes of this subsection, the term "grossly erroneous items" means, with respect to any spouse —

(A) any item of gross income attributable to such spouse which is omitted from gross income, and

(B) any claim of a deduction, credit, or basis by such spouse in an amount for which there is no basis in fact or law.

(3) SUBSTANTIAL UNDERSTATEMENT. — For purposes of this subsection, the term "substantial understatement" means any understatement (as defined in section 6661(b)(2)(A)) which exceeds $500.

(4) UNDERSTATEMENT MUST EXCEED SPECIFIED PERCENTAGES OF SPOUSE'S INCOME. —

(A) ADJUSTED GROSS INCOME OF $20,000 OR LESS. — If the spouse's adjusted gross income for the preadjustment year is $20,000 or less, this subsection shall apply only if the liability described in paragraph (1) is greater than 10 percent of such adjusted gross income.

(B) ADJUSTED GROSS INCOME OF MORE THAN $20,000. — If the spouse's adjusted gross income for the preadjustment year is more than $20,000, subparagraph (A) shall be applied by substituting "25 percent" for "10 percent".

(C) PREADJUSTMENT YEAR. — For purposes of this paragraph, the term "preadjustment year" means the most recent taxable year of the spouse ending before the date the deficiency notice is mailed.

STATEMENT OF THE CASE

During the taxable years in question, 1964 through 1969, and until the present, Petitioner Lillian K. Shenker was married to Morris A. Shenker. For the years 1964-1969 inclusive, Mr. Shenker and Petitioner signed and filed joint federal income tax returns. Throughout this period Mr. Shenker, who is an attorney, was engaged in various business activities, including a partnership for the operation of certain commercial real estate located at the intersection of First and C Streets in San Diego, California and known as the Electronics Capitol Building ("the Building").

The Commissioner determined deficiencies in income tax based upon disallowance of the loss deductions claimed by Mr. Shenker on his and Petitioner's joint returns for 1966 through 1969 for his share of the losses sustained in operation of the Building by the Electronics Capitol Building partnership ("ECB"). The Commissioner determined that because ECB used a corporate agent to manage the Building, Mr. Shenker had no ownership interest in the real estate for tax purposes and the losses of the Building operation were attributable to the corporate agent. The Commissioner reached this determination even though Mr. Shenker owned no interest in that corporation and had indemnified it against liabilities arising out of its agency under an indemnity contract in writing. (Pet. App. A-6)

A joint petition for redetermination of deficiencies was filed in the United States Tax Court. Petitioner was a party only because of her having signed the joint returns. Following a stipulation of facts and a trial on the merits, the Tax Court took the case under submission. Thereafter and before entry of findings and opinion in the case, Congress amended[1] Section 6013(e) of the Internal Revenue Code of 1954[2] to broaden the scope of relief of the innocent-spouse statute. Under prior law, certain spouses were relieved of joint and several liability on income tax returns only in case of understatements of tax resulting from omissions from gross income. The 1984 Act extended relief to an innocent spouse from certain understatements of tax resulting from claims of deduction, credit, or basis by the other spouse. Relief was extended retroactively to all taxable years governed by the 1954 Code in any case still pending at the time of enactment, thus bringing the instant case within the purview of the Act.

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[1] § 424 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984).

[2] All sections cited refer to the Internal Revenue Code of 1954 unless otherwise indicated.

Petitioner timely filed on April 5, 1985, a motion for supplemental evidentiary hearing in order to present evidence excusing her from liability under amended Section 6013(e) (Pet. App. A-23 - 24). The Tax Court denied this motion in its memorandum findings and opinion (Pet. App. A-1), in which the deficiencies determined against Mr. Shenker and Petitioner were upheld. On appeal, the Eighth Circuit Court affirmed (Pet. App. A-27).

The material facts established by the record are as follows.

Morris A. Shenker invested in several real estate projects owned or controlled by Irving J. Kahn, a client and close friend (Pet. App. A-2), including the Building.

This project was originally constructed between 1961 and 1963 by its original developer, First and C Corporation (hereinafter "F&C"). Kahn held the stock of F&C with three others: Lawrence Holzman, Louis Lesser (through a corporation), and James S. Murphy (Pet. App. A-3). In August 1963, construction financing loans were satisfied by a permanent mortgage loan of $4,000,000 from Prudential Insurance Company of America, secured by a mortgage on the property and personal guaranties of the shareholders (Pet. App. A-3). F&C gave its second mortgage six months later to Great Universal Development Company, Inc. to secure a second loan of $350,000.

The project operated at a loss and was soon in financial trouble. By February, 1965, the shareholders had advanced a total of $158,894 to meet cash deficits. When they were no longer able to loan capital to F&C, the corporation defaulted on certain obligations, and creditors brought suits against the shareholders on their personal guaranties (Pet. App. A-4).

In order to maintain the solvency of the Electronics Capitol Building operation, Kahn arranged for donveyance of the property and assignment of the tenant leases by F&C to Penas-

quitos Corporation ("Penasquitos") on March 4, 1966. In return, Penasquitos assumed all the debts of F&C, including the Prudential mortgage obligation, and issued its non-interest-bearing promissory note for $1,047,780 to F&C (Pet. App. A-5). F&C, in turn, assigned the Penasquitos note to Lesser and Kahn in shares proportional to their previous advances to F&C (Pet. App. A-4 - 5). The debts assumed by Penasquitos totaled in excess of $4,813,000 (Pet. App. A-4). Penasquitos was then a previously-existing real estate development corporation controlled by Kahn, with assets in excess of $10,000,000, including 14,000 acres of land within the San Diego city limits (Pet. App. A-5).

Before the conveyance to Penasquitos, Kahn had approached Mr. Shenker to raise funds for the Building. On March 21, 1966 an agreement, dated March 4, 1966, was signed whereby Penasquitos purportedly agreed to act as agent for Kahn and Mr. Shenker in the acquisition and management of the Building. Kahn and Mr. Shenker were undisclosed principals (Pet. App. A-5). Penasquitos established bank accounts in its name doing business as Electronics Capitol Building. Penasquitos kept the records and alone managed operation of the Building through its employees until at least April 4, 1967 (Pet. App. A-5 - 6). No agency fees, however, were at any time paid to Penasquitos.

Mr. Shenker arranged a loan on June 23, 1966 from the State Bank and Trust Company of Wellston to Penasquitos in the amount of $250,000, the proceeds of which were used by Penasquitos for a variety of corporate purposes. Mr. Shenker took no part, however, in any management decisions relating to the Building (Pet. App. A-6). No partnership agreement was signed, but the Electronics Capitol Building partnership ("ECB") filed partnership returns for the years in question, commencing with 1966. Mr. Shenker was listed each year as a partner, either with Kahn or with his successors in interest in ECB (Pet. App. A-7 - 8).

On April 4, 1967, Penasquitos, Kahn, and Mr. Shenker signed an agreement terminating the agency, holding Penasquitos harmless for claims arising out of its operation of the Building, and assuming all its obligations incurred thereby. On the same day, by written agreement, Sidney Wyman and Charles Rich acquired Kahn's 50 % interest in ECB in exchange for funds previously loaned to Kahn (Pet. App. A-6). In April, 1967, Penasquitos conveyed the Building to Title Insurance and Trust Company of San Diego ("Title Company"), pursuant to a holding agreement among Title Company, Rich, Wyman, and Mr. Shenker, whereby Title Company would hold legal title to the Building as their agent (Pet. App. A-6).

After April, 1967, either Penasquitos or the Kahn Organization (another Kahn-controlled entity) operated the Building. The Kahn Organization was to receive a management fee of 50 % of the net income of ECB under the Rich-Wyman purchase agreement (Pet. App. A-7). Penasquitos employees continued to maintain the bank account, collect rents, and pay bills (Pet. App. A-16).

In June, 1967, Mr. Shenker arranged and guaranteed a $60,000 loan from the Industrial Bank of Binghampton to Penasquitos which treated this debt on its books as a loan from Mr. Shenker and remitted interest payments to the lender (Pet. App. A-7).

On November 8, 1967, the Thrift Credit Corporation loaned an additional $100,000 to Mr. Shenker, Wyman, and Rich for use in ECB (Pet. App. A-7), secured by deeds of trust. ECB borrowed $100,000 from Wyman for operating expenses on December 15, 1967 and paid to Mr. Shenker $50,000 on the same day and an additional $45,000 on December 27, 1967.

ECB reported operating losses on its partnership returns in each subject year, and Mr. Shenker claimed deductions of his distributive shares of losses on his and Petitioner's joint returns as follows:

1966	$168,684
1967	171,925
1968	53,612
1969	75,417

The Tax Court found as an ultimate fact that neither Mr. Shenker nor his ECB partnership owned any interest in the Building during any such year, concluding that in substance no agency relationship existed between Penasquitos and ECB, such that the operating losses of the Building are attributable to Penasquitos as a separate entity.

Before April 4, 1967, Penasquitos managed the Building and handled all accounts receivable and payable. Penasquitos assumed and incurred indebtedness in excess of five million dollars upon its acquisition of title, and "in all other respects acted as the true owner of the property" (Pet. App. A-16). Mr. Shenker's involvement as principal was kept undisclosed as a blind to creditors, and so the Tax Court concluded that he was not actually bound to the debts of Penasquitos (Pet. App. A-16). Mr. Shenker took no part in management of the Building, and all of its income was attributable to Penasquitos's efforts (Pet. App. A-16). "...Penasquitos alone assumed the burdens and benefits of ownership," by undertaking these obligations without compensation (Pet. App. A-18).

Even after the conveyances to Title Co. of April 4, 1967, concluded the Tax Court, Mr. Shenker did not obtain any ownership for tax purposes in the Building (although the court did not decide who did). Authority over the operation and funds of the Building remained entirely with Penasquitos or the Kahn Organization, which acted on their own behalf (Pet. App. A-20). Mr. Shenker's guaranties of loans of $250,000 and $60,000 to Penasquitos and its payment to him of $50,000 and $45,000 in 1966 and 1967 were held to comport fully with a debtor-creditor relation (Pet. App. A-21).

Therefore at no time during 1966 through 1969 was Mr. Shenker held to have assumed the burdens or benefits of ownership of the Building or to be entitled to claim loss deductions of Penasquitos.

Petitioner took no role in the ECB partnership, the operation of the Building, or the various agreements between Mr. Shenker and Kahn, Penasquitos, Wyman, Rich, Title Company and the lender banks. (Stip. 4, Pet. App. A-2).

SUMMARY OF ARGUMENT

The understatement of tax at issue results from the Tax Court holding that Mr. Shenker did not assume the benefits and burdens of ownership of the Building, which was managed during the years in question by a non-owned corporate agent, and so could not report the losses of its operation. It was undisputed below that Petitioner was a party to the case only because she had signed the joint returns in question and that Penasquitos, the agent, engaged in substantial business activity in the management of the Building, with respect to which Mr. Shenker deducted loss expenses. The correctness of that deficiency determination as against Mr. Shenker is not in dispute on this Petition. The issue is, rather, whether his deduction claims were "grossly erroneous" within Section 6013(e)(2) so as to qualify Petitioner for innocent-spouse relief. This question, under the statutory definition of "grossly erroneous," requires the inquiry whether Mr. Shenker's erroneous deduction claims had "no basis in fact or law" within Section 6013(e)(2)(B), such that the Tax Court might properly refuse Petitioner any evidentiary hearing.

The Courts below disregarded the mandate of this statutory definition. They reasoned that the expenses claimed were deductible under the tax law and were in fact incurred, by Penasquitos. Therefore, the deduction claims could not be considered fraudulent. Since Mr. Shenker presented non-frivolous legal arguments to support his claim to report the losses of Penasquitos, the lower courts deemed his position sufficiently

meritorious to bar his wife's right to relief as an innocent spouse, although insufficient for Mr. Shenker to prevail against the Commissioner.

The holdings below completely ignore the fact that, under the substantive tax law as declared therein, no fact presented by Mr. Shenker negates the recognition of Penasquitos as the loss-reporting entity. His claims have been litigated. The Tax Court (despite contrary dictum) has found no basis in fact or law to sustain his deduction claim. Accordingly, Petitioner should be given the chance to show her right to relief as an innocent spouse by proof at an evidentiary hearing of (1) her lack of knowledge of the understatement of tax on the subject returns and (2) the unjustness of her being held liable for those understatements. Since Petitioner's request for hearing was denied, these elements of her claim for relief are to be taken as true on this Petition. The arbitrariness and unreasonableness of the decision below is compounded by the suggestion that the absence of fraud on the part of Mr. Shenker bars his wife's right to relief. It is repugnant that a taxpayer, otherwise entitled to relief, should suffer solely because of her husband's honesty.

No fact presented by Mr. Shenker was held relevant to sustain his loss deduction. His claim is therefore established as having no basis in either fact or law, if "fact" and "law" be separable. His wife should be permitted to make her case for relief.

The issue is of great importance, and the public would not be served by its disregard. Millions of taxpayers file joint returns of income tax and are, often unknowingly, exposed to the hazards of joint and several liability. Many spouses face, as does this Petitioner, ruinous liabilities arising out of their spouses' separate business activities, which are beyond their understanding or power to monitor and police. The narrow construction given to the innocent-spouse statute in the holding below vitiates and defeats its remedial purpose including the broad purpose to afford to spouses in common-law jurisdictions the benefits available to those residing in civil law community-property jurisdictions.

REASONS FOR GRANTING THE WRIT

I

The Tax Court Has Determined That Morris A. Shenker's Loss Deduction Claims Lack A Basis In Fact Or Law; Petitioner Is Therefore Entitled To A Hearing On Her Right To Relief As An Innocent Spouse.

No issue is presented of Petitioner's lack of knowledge of her husband's affairs or of the inequity of holding her liable for this understatement in tax, becasue the Tax Court denied her any opportunity to present evidence on these issues. Rather, the pivotal issue is whether Mr. Shenker's deduction of losses from property in which he had no ownership have, as the Tax Court held, a basis in fact or law simply because the expenses claimed were incurred by and properly deductible by somebody, such that his claim was, as a matter of law, not "grossly erroneous" (Pet. App. A-26). The rationale of the Court of Appeals, that Mr. Shenker's legal arguments were unmeritorious but still had enough substance to constitute a legal *and* factual basis for his claim, is equally specious (Pet. App. A-38)

A. The Innocent-Spouse Statute and Its History.

Section 6013(e) of the Internal Revenue Code, as amended by Section 424(a) of the Tax Reform Act of 1984, enacted July 18, 1984, provides in pertinent part that if on a joint return "there is a substantial understatement of tax attributable to grossly erroneous items of one spouse," and if the other spouse establishes that she did not know or have reason to know of the understatement, and that it is "inequitable to hold" her liable for it, then she shall "be relieved of liability for tax ... attributable to such ... understatement." "Grossly erroneous items" are defined to include any omission of income and "any claim of a deduction, ... by such spouse in an amount for which there is no basis in fact or law."

The Tax Court held that first, as a matter of economic substance, Mr. Shenker had never assumed the benefits and burdens of ownership of the Building because Penasquitos had acted as principal, rather than agent, in its operation of the Building under the six-factor corporate-agent test set forth in *National Carbide Corp. v. Commissioner,* 336 U.S. 422, 438-439 (1943). Second, the Tax Court held that, as a matter of law, Mr. Shenker's loss deduction claims with respect to ECB were "not without legal basis" and so "do not constitute 'grossly erroneous items' under the [innocent-spouse] statute." (Pet. App. A-26). Accordingly, all of the factual allegations of Petitioner's motion for supplemental hearing (Pet. App. A-25) are to be taken as true. The sole issue presented on this appeal is whether her husband's ECB loss deductions are "grossly erroneous," which, under the definitional section of the statute, is narrowed to the question whether his claims are without basis in fact or law.

This question is one of first impression in this Court. Legislative history is scanty and so must begin with the history of the statute. Congress originally enacted the joint-return statute, the predecessor of Section 6013(e), in response to the celebrated decision of the Supreme Court in *Poe v. Seaborn,* 282 U.S. 101 (1930), which held that a wife living in a community-property state had the right to report separately her half share of her husband's community income. The joint-return provisions enacted after *Seaborn* permitted spouses in common-law states to enjoy the same income-splitting benefit but, for reasons of administrative simplicity, conditioned that benefit upon joint and several liability for all tax due on the return. This 100% vicarious liability attached even though a married person in a community-property state returning separately his share of community income would not have had liability for tax (based either on omissions or erroneous deduction claims) to the extent of the other spouse's separately reported community share.

Accordingly, the Service asserted deficiencies and fraud and negligence penalties against spouses regardless of their knowledge or participation, and cases of grave injustice arose. The courts appealed to Congress for reform:

> ... the inflexible [joint-return] statute leaves no room for amelioration. It would seem that only remedial legislation can soften the rule of strict individual liability for income taxes on the many married women who are unknowingly subjected to its provisions by filing joint returns. *Louise M. Scudder,* 48 T.C. 36, 41 (1967), cited in S. Rep. No. 91-1537, 1971-1 Cum. Bull. 606, 607.

Congress acted to prevent the imposition of strict liability for an understatement of tax "on the spouse even though she had no knowledge of her husband's activities and the resulting omission from income, and even though she did not benefit in any way from the use of the income." S. Rep. No. 91-1537. The Senate Finance Committee stated explicitly that the purpose of the legislation was "to bring government tax collection practices into accord with basic principles of equity and fairness" and that "[t]his provision has applicability to an omission from gross income and is not limited to embezzlement, theft, or similar activities." *Id.*

Although a taxpayer asserting innocent-spouse relief bears the burden of proof, the courts have

> correctly recognized that Section 6013(e) is a remedial statute: "Congress intended the [innocent spouse] exception to remedy a perceived injustice, and we should not hinder that praiseworthy intent by giving the exception an unduly narrow or restrictive reading." *Sanders v. United States,* 509 F.2d 162, 166-167 (5th Cir. 1975), quoted in *Ballard v. Commissioner,* 740 F.2d 659, 664 (8th Cir. 1984).

In this liberal spirit, the courts have been reluctant to find that a truly ignorant spouse should have known of omissions or

that she has received a disqualifying "benefit." The *Ballard* opinion reflects settled law that (1) "ordinary marital support ... does not put a spouse on notice of omitted income," and (2) signature of the joint return at the other spouse's request without substantive review (however unwise in light of the penalties for perjury) does not require the conclusion that the spouse had reason to know of an omission, 740 F.2d at 664.

These particular issues (knowledge of understatement in tax and equitableness of relief under Section 6013(e)(1)(C) and (D)) are not presented on this Petition, but these decisions indicate (in the absence of other authority) the appropriate approach to interpretation of the new amendment of the innocent spouse statute: broad construction to make effective the legislative purpose.

The plain language of former Section 6013(e), however, constrained the courts to hold that improper deductions from gross income did not constitute omissions and so that no relief was available under the statute from tax liability arising from such erroneous deductions. Congress determined in 1984 that the statute should be liberalized by expanding the circumstances under which relief may be granted to include understatements in tax attributable to certain claims of deduction, basis, and credit:

> The committee believes that the present law rules relieving innocent spouses from liability for tax on a joint return are not sufficiently broad to encompass many cases where the innocent spouse deserves relief. Relief may be desirable, *for example,* where one spouse claims phony business deductions in order to avoid paying tax and the other spouse has no reason to know that the deductions are phony and may be unaware that there are untaxed profits from the business which the other spouse has squandered. H. Rep. 98-432, Part 2, 98th Cong. (Empahsis supplied.)

B. Mr. Shenker's Loss Deduction Claim Is "Grossly Erroneous" Within Section 6013(e).

A familiar canon of statutory construction is that the court must apply definitions specified in the statute. Otherwise, the effect given to the statute cannot agree with the reasonable understanding of the members of the public to whom the statute is addressed. 2A Sutherland, *Statutory Construction,* (4th Ed.) pp. 33, 132. The interpretation of federal tax statutes is no different in this respect from other statutes. Accordingly, the meaning of "grossly erroneous items" is not that of common speech, frivolous or insubstantial, but rather is the meaning assigned to the term by Congress: a claim in an amount lacking a basis in fact or law.

Under a plain-meaning interpretation, the denial of a supplementary hearing to Petitioner conflicts with the holding on the underlying deficiency issues. If Mr. Shenker's loss deduction claim has legal and factual basis, it should be allowed. If not, then Petitioner should be given a hearing on her motion.

If, in response, the Commissioner urges that the decision below must be affirmed because Mr. Shenker's beneficial ownership of the Building under state law does not amount to ownership for tax purposes, then the same standard governs Petitioner's rights under Section 6013(e). In other words, if (as the Commissioner has contended herein) Mr. Shenker's substantive-law ownership and the actual payment by Penasquitos of expenses under its agency contract with the ECB partnership are irrelevant to the benefits-and-burdens-of-ownership test established by governing case law, then these facts are also irrelevant to the inquiry whether Mr. Shenker's deduction claims have a factual basis. Thus the requirement of no-basis-in-fact-or-law is conjunctive, rather than disjunctive. A basis in fact for innocent-spouse purposes can exist only in facts which the underlying tax statute makes pertinent.

Thus, if two cohabiting but unwed taxpayers file a joint return and the state of their residence does not recognize common-law marriage, then the fact of cohabitation is irrelevant to their right to file a joint return or to any claim of deduction or credit based on the pretended marriage. Cohabitation is made irrelevant by the law and so, *a fortiori,* establishes no factual basis. What constitutes a basis in fact or law is discernible only in the context of the substantive law imposing the tax.

Penasquitos's extensive control of Building management, its assumption of over four million dollars in F&C debts, and its issuance of a promissory note for more than one million dollars, all without compensation, were inconsistent with the way a real agent would conduct business. The purported assignment by Kahn to Mr. Shenker of a half-interest in the Building without any cash investment and with very small loan guaranties as his only consideration lacks economic substance. The Tax Court's redetermination of the deficiency against Mr. Shenker could have been affirmed on the basis of evidence in the record showing the substance over form, that the transaction reflects extension of credit by Mr. Shenker to Penasquitos rather than true ownership of the Building by ECB partners. (Pet. App. A-20 - 21.) If so, then factual basis for Mr. Shenker's claim is entirely lacking, and Petitioner is qualified to seek innocent-spouse relief.

The larger purpose of Section 6013(e), dating from its original enactment, is to give to the federal courts the power to do equity and to grant relief to spouses from vicarious liabilities where justice requires. Relief from liability for omitted income items has never been limited to cases of fraud or frivolousness. The Commissioner and the Courts below ignore the historical and policy context of the 1984 amendment, which was intended to expand the scope of relief previously afforded and to further the original purpose of "brin[ging] government tax collection practices into accord with basic principles of equity and fairness." S. Rep. No. 91-1537, 1971-1 Cum. Bull. 606, 607.

CONCLUSION

The Petition for Certiorari should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX A

T. C. Memo. 1985-301

UNITED STATES TAX COURT

MORRIS A. SHENKER and LILLIAN K. SHENKER, Petitioners vs. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 9961-77. Filed June 24, 1985.

James F. Nangle, Jr., for the petitioners.

Henry C. Lowenhaupt, for petitioner, Lillian K. Shenker, as of June 5, 1985.

James F. Kidd and *Robert R. Rubin,* for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WILES, *Judge:* Respondent determined the following deficiencies in petitioners' Federal income taxes:

Year	Deficiency
1964	$ 473.00
1965	925.00
1966	99,461,00
1967	130,359.00
1968	77,262.00
1969	16,237.00

After concessions, the primary issue for decision is whether petitioner, Morris A. Shenker, acquired an ownership interest in various buildings, entitling him to claim deductions attributable to the respective properties.

We will also consider petitioner Lillian K. Shenker's motion for supplemental hearing filed with the Court April 5, 1985.

FINDINGS OF FACT

Morris A. Shenker and Lillian K. Shenker, husband and wife, resided in St. Louis, Missouri, when they filed their petition herein. Petitioners filed joint Federal income tax returns for their 1964, 1965, 1966, 1967, 1968, and 1969 taxable years with the Internal Revenue Service Center in Kansas City, Missouri. Petitioner Lillian K. Shenker, is a party herein solely because she filed joint returns with her husband for the years in issue. Hereinafter all references to "petitioner" refer to Morris A. Shenker.

Petitioner is an attorney specializing in criminal law who has actively practiced law in the St. Louis area for approximately 50 years. In or about 1964, petitioner first represented Irvin J. Kahn (hereinafter Kahn) involving Parkway Bowl, a bowling alley in which Kahn was a partner. In this regard, petitioner obtained the loan for Kahn from the Teamsters Pension Fund in Chicago, Illinois. Throughout the years in issue, Kahn was the head of "Irvin J. Kahn Organization," a corporation providing accountants, lawyers, computer facilities, and other miscellaneous administrative services to about 75 business entities owned and operated by Kahn and others (hereinafter referred to as the Kahn Organization). There were 25 to 40 accountants, some of whom were certified public accountants, on the staff. From 1964 through Kahn's death on September 10, 1973, petitioner represented Kahn in matters relating to various business entities owned or controlled by Kahn. Throughout the years, petitioner and Kahn became close friends.

During the years in issue, petitioner invested in various real estate projects owned or controlled by Kahn. As is relevant to the case herein, petitioner became involved in the following three projects located in San Diego, California: The Electronics Capital Building, a 23-story office building (hereinafter referred to as ECB); Loma Palisades, an apartment complex; and Pennant Village, a 128-unit apartment complex. From 1965

through 1969, there was a recession in San Diego resulting in a depressed real estate market, which caused each of these projects to go into default. Kahn, in an attempt to keep the projects solvent, contacted petitioner for additional capital. We will discuss the facts surrounding petitioner's involvement in the three projects separately.

Electronics Capital Building

Construction of ECB commenced in April 1961 and was completed on May 1, 1963, by its original owner, First and C Corporation (hereinafter F & C). At all relevant times, the stock of F & C was held by four shareholders: Lawrence Holtzman, James S. Murphy, Louis Lesser, and Kahn.[1] Kahn was an officer and director of F & C. Construction of ECB was financed by two loans; one in the amount of $2,700,000 from Fidelity Bank and the other in the amount of $1,100,000 from Pacific Finance Corporation. Upon completion of the project, in August 196, F & C satisfied the two construction loans with a $4,000,000 permanent mortgage loan from Prudential Insurance Company of America. This loan was secured by a mortgage on ECB and by the personal guarantees of Kahn, Murphy, and Lesser. Within six months, F & C required additional capital and, on March 19, 1964, it obtained a $350,000 loan from Great Universal Development Company, Inc., secured by a second mortgage on ECB.

Not long after completion of ECB, F & C was in very serious financial difficulty. Its financial problems were caused by several factors including the depressed real estate market and the announcement of the construction of the two new highrise office buildings. F & C continued to operate ECB at a loss by

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[1] Kahn, Lesser, and Murphy each owned 15,100 shares while Holtzman owned 9,100 shares.

borrowing money from its shareholders.[2] As a result of mounting operating cash deficits, F & C attempted to negotiate modified payment plans with several of its creditors. F & C's problems became evident when three of its shareholders were no longer financially able to loan additional capital to the corporation. F & C began to default on several of its obligations, and lawsuits were brought against the four shareholders on their personal guarantees.

Due to the financial incapacity of the other shareholders, Kahn was called upon in his individual capacity to maintain the continued solvency and operation of F & C. Kahn felt that given the potential liability and lawsuits against the other shareholders no new party would invest in ECB unless legal title to ECB was placed in the name of the Penasquitos Corporation (hereinafter Penasquitos).

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[2] For the year ending April 30, 1965, F & C had a cash deficit of over $400,628. F & C sustained a $221,692.33 net operating loss on ECB for the 8-month period ending December 31, 1965. By February 16, 1966, F & C had the following liabilities (rounded):

Creditor	Amount
Prudential	$3,896,177
Great Universal	350,000
Southland Savings	55,673
Westinghouse Credit Corp.	216,960
Associates Discount	35,749
C. H. Masland & Sons	21,328
Delinquent Taxes, penalties and interest	87,414
Reserve for additional tenants improvements	150,000

To keep F & C solvent, the shareholders advanced money to the corporation in the following amounts:

Shareholder	Amount Advanced
Kahn	$ 29,005.60
Lesser	739,674.01
Murphy	183,214.46
	$1,158,894.07

Penasquitos was a real estate developement corporation, controlled by Kahn, with assets totaling in excess of 10 million dollars. At all relevant times, Penasquitos was an ongoing solvent corporation formed to develop approximately 14,000 acres of land with the San Diego limits. On March 4, 1966, F & C deeded ECB to Penasquitos. F & C assigned all ECB leases to Penasquitos. In exchange, Penasquitos assumed all outstanding indebtedness owed by F & C to its various creditors, including the mortgage obligation to Prudential[3], as well as executing a promissory note in the amoutn of $1,047,779.66 to F & C. This note, which was non-interest-bearing, provided for payment on March 4, 1976, with the option to make partial or full prepayments at anytime.[4] After acquisition of ECB, Penasquitos established bank accounts in its name doing business as ECB. Penasquitos kept the books and records of ECB and managed the day-to-day activities of the building. On March 21, 1966, an agreement, dated March 4, 1966, was executed whereby Penasquitos agreed to act as an agent for Kahn and petitioner for the acquisition and operation of ECB. Kahn and petitioner were undisclosed principals of this agency agreement.

Prior to March 4, 1966, petitioner was in no way connected with, nor did he own any interest either directly or indirectly in, ECB. Sometime early in 1966, Kahn, seeking additional capital

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[3] Pursuant to paragraph 4 of the sales agreement executed on March 4, 1966, Penasquitos "assumes and agrees to pay all delinquent amounts of principal, interest, penalties and costs in connection with encumbrances of record against * * * [ECB] * * *. In addition, paragraph 7 provides "the total consideration for * * * [ECB] * * * is agreed to be the aggregate of the following, calculated as of the date hereof: A. Principal and accrued but unpaid interest owing to The Prudential Insurance Company of America; * * *."

[4] On March 4, 1966, F & C assigned Louis Lesser Enterprises, Inc., a $798,774.01 interest in Penasquitos's note and assigned Kahn a $249,005.65 interest in the note. On August 16, 1968, all rights, title, and interest in Penasquitos's note was transferred to Kahn without recourse.

to bail out ECB, approached petitioner. Petitioner was willing to invest in ECB. In this capacity, petitioner arranged for a $250,000 loan from the State Bank and Trust Company of Wellston to Penasquitos on June 2, 1966. This loan was evidenced by a $250,000 note from Penasquitos secured by a first deed of trust on two parcels of land, by petitioner's and Kahn's personal guarantees. During the period March 4, 1966 through April 4, 1967, Penasquitos alone actively managed ECB. Petitioner was not involved in any decisions relating to the operation of ECB.

On April 4, 1967, an agreement was executed between Penasquitos, petitioner, and Kahn. The agreement generally provided that petitioner and Kahn (1) terminated the agency relationship with Penasquitos; (2) agreed to hold Penasquitos harmless for any and all claims arising from or connected with Penasquitos's operation of ECB; and (3) assumed all liabilities and obligations incurred by Penasquitos in operating ECB. That same day, Sidney Wyman and Charles Rich allegedly acquired Kahn's interest in ECB. Pursuant to an agreement, each of them purchased an undivided twenty-five percent interest in ECB for the amount of $200,000 which was previously advanced to Kahn.[5] In April 1967, Penasquitos deeded legal title to ECB to Title Insurance and Trust Company of San Diego (hereinafter Title Company). About the same time, petitioner, Rich, and Wyman, executed a holding agreement with the Title Company which provided that the Title Company would hold title to ECB as an agent for them.[6]

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[5] The agreement further provided that the Kahn organization would manage ECB for fifty percent of the net income generated by ECB. The organization was appointed as an agent for Rich and Wyman, responsible for the operation and management of ECB, including collecting rents, opening of new bank accounts, and making payments on existing encumbrances.

[6] The record is ambiguous as to when this holding agreement was actually executed. From the record before us, we conclude that the agreement was executed sometime between April 4, 1967 and September 5, 1969.

After April 1967, ECB was supposedly operated by the Kahn organization and/or Penasquitos.[7] Pursuant to an agreement with Rich and Wyman, the Kahn organization received a management fee of fifty percent of the net income from ECB.

In June 1967, petitioner arranged a personal loan to Penasquitos for ECB with the Industrial Bank of Binghamton in the amount of $60,000. This loan was personally guaranteed by petitioner and was treated on the books of ECB as a loan from petitioner to the project. The loan proceeds were used to pay $50,000 of principal on the $350,000 note which was subsequently purchased by Thrift Credit Corporation. The Industrial Bank of Binghamton sent petitioner invoices for interest due on the $60,000 loan to ECB; however, these bills were not paid by petitioner, rather, they were paid from ECB's bank account.

On November 8, 1967, an additional loan was obtained from the Thrift Credit Corporation in the amount of $100,000. This loan was secured by a deed of trust executed by petitioner, Wyman, and Rich and the original deed of trust to the Title Insurance and Trust Company dated March 19, 1964. In order to meet its operating expenses ECB borrowed $100,000 from Wyman on December 15, 1967, which was to be returned in 45 days. On that same day, ECB paid petitioner $50,000 and on December 29, 1967, ECB paid petitioner an additional $45,000.

ECB filed U.S. Partnership returns (Forms 1065) for the taxable years ending 1966, 1967, 1968, and 1969, reporting losses in the amounts of $337,367.84, $351,315.59, $114,969.31, and $162,117.00, respectively. During each year in issue, petitioner

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[7] The record, however, is somewhat ambiguous as to which corporation acutally operated ECB after April 4, 1967. There is some indication that Penasquitos continued to manage ECB. ECB's checking account, which was established on March 4, 1966, remained unchanged after April 4, 1967. In addition, Penasquitos made payments on ECB's loans from Industrial Bank of Binghamton, Thrift Credit Corporation, and petitioner.

was listed as a partner on ECB's partnership returns along with Kahn and/or Wyman and Rich.[8]

On his 1966, 1967, 1968, and 1969 Federal income tax returns, petitioner claimed his distributive share of ECB's losses in the respective amounts of $168,684, $171,925, $53,612, and $75,417.

Loma Palisades

Construction began on the apartment complex known as Loma Palisades Apartments during 1958 and was completed by the end of 1959. Loma Palisades Apartment complex (Loma Apartments) was divided into five units designated A through E, each unit being put into a separate corporation (hereinafter the five separate corporations are collectively referred to as the Loma corporations). Financing for the project was accomplished with mortgage guarantees provided by the Federal Housing Administration (hereinafter FHA). The FHA insured five mortgages aggregating $6,292,100. From the onset, the apartment complex was plagued by a high vacancy factor, approaching 40 percent. Because of the lack of tenants, rental payments did not meet expectations and the mortgages guaranteed by the FHA went into default.

In about 1960, the Loma corporations commenced negotiations with the Kahn Organization for sale of their common stock. In the latter part of 1960, Kahn and certain others, through a corporation known as University City, acquired ownership and control of the project by purchasing the stock of the Loma corporations. In 1964, ownership and control of University City was transferred to a group headed by Mr.

[8] No partnership agreements were ever executed by the partners. Respondent has conceded, however, that if petitioner is found to have acquired an ownership interest in ECB, his claimed losses will not be denied because of the absence of either a partnership agreement or sufficient basis.

Carlos Tavares (hereinafter Tavares). The FHA was notified on January 22, 1965, that the principal shareholders of University City (which owned the Loma corporations) were Tavares, Louis Lesser, and C. W. Carlstrom. In 1966, the project again went into default, and on June 3, 1966, a complaint was filed in the United States District Court for the Southern District of California, Southern Division, against Loma Palisades, Inc., and Title Insurance and Trust Company. By order dated June 13, 1966, the court appointed a temporary receiver for each of the five Loma corporations. During the pendency of the receivership, the receiver managed the Loma Apartments, including the collection of all income and payment of all expenses.

On April 5, 1967, each Loma corporation contracted to sell petitioner and 220 North Kings Highway, Inc.[9] (hereinafter 220, Inc.), its respective apartment units. In turn, petitioner and 220, Inc., agreed to cure existing delinquency on the mortgages guaranteed by the FHA and to assume the existing unpaid balances of the five mortgages on the property. On April 11, 1967, deeds conveying Loma Apartments to petitioner and 220, Inc. were executed by each of the Loma corporations and delivered to petitioner.

Pursuant to the sales contract of April 5, petitioner tendered to the FHA a cashier's check dated that same day in the amount of $200,000 to cure the delinquency on the five mortgages. The check was drawn on the First National Bank of St. Louis by 220, Inc. By letter dated April 12, 1967, Harry L. Johnson submitted an application to the FHA for the transfer of the physical assets of Loma Apartments from the Loma corporations to petitioner and 220, Inc. Enclosed with the letter were copies of the deeds executed on April 11, copy of the sales contract dated April 5, and the cashier's check in the amount of $200,000, dated April 5. The FHA, however, did not cash the check for over a year.

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[9] 220 North Kings Highway, Inc., was a corporation owned by petitioner's wife's family.

On August 15, 1967, the receiver paid to the State of California taxes totaling $29,886.12 on the gains reported on the April 11 transfer of the properties by Loma corporations to petitioner and 220, Inc. On November 3, 1967, petitioner and 220, Inc., received preliminary approval from the FHA on the transaction. The deeds executed on April 11, 1967, were recorded on June 26, 1968. On July 3, 1968, the receiver approved the transfer and the receivership was terminated shortly thereafter.

U. S. Partnership returns (Forms 1065) were filed for Loma Palisades for the 1967 and 1968 taxable years reporting losses in the amounts of $223,933.74 and $251,834.57, respectively. During each year in issue, petitioner was listed as a partner on Loma Palisades partnership returns.[10] On petitioner's 1967 and 1968 Federal income tax returns, petitioner claimed his distributive share of the losses arising from the operation of Loma Palisades in the respective amounts of $111,967 and $67,606.02.

Pennant Village

Pennant Village, a California corporation, was incorporated on July 16, 1964, to construct an apartment complex located in San Diego, California.[11] Pennant Village obtained a $2,000,000 loan for permanent financing of the project from Fidelity Bank of Beverly Hills, California. This loan was insured by the FHA and secured by a deed of trust giving Fidelity Bank a first mortgage on the property. Additional security for the loan was provided by Kahn and Tavares who jointly and severally guaranteed the loan to Fidelity Bank for two years following the date of the first payment on the note.

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[10] No partnership agreements were ever executed by the partners. Respondent has conceded, however, that if petitioner is found to have acquired an ownership interest in the Loma Apartments, his claimed losses will not be denied because of the absence of either a partnership agreement or sufficient basis.

[11] Pennant Village Corporation was a wholly owned subsidiary of University City. Petitioner was not a shareholder, officer or director of either Pennant Village Corporation or University City.

On or after February 1, 1966, Pennant Village went into default. The mortgagor brought suit against the corporation demanding payment of the delinquent amounts and possession of the property and, in the interim, appointment of a receiver to take over operation of the apartment complex. On May 25, 1966, Herman A. Bischoff was appointed receiver by the court. During the pendency of the receivership, the receiver managed the property including collection of all rents and payment of all expenses. On August 10, 1967, the FHA was substituted as plaintiff in the suit against Pennant Village Corporation.

The FHA threatened foreclosure on Pennant Village if the mortgage was not properly brought up to date. Between November 8, 1966 and December 14, 1966, Kahn and the FHA corresponded a number of times pursuing ongoing negotiations of the resolution of the Pennant Village situation. During the same time, petitioner was induced by Kahn to provide capital and assist Kahn in bailing out the Pennant Village project. In a letter dated December 7, 1966, Kahn advised the FHA that he and petitioner would cure default and that title to the property would be transferred to them. On December 12, 1966, Pennant Village Corporation executed and delivered a corporation grant deed conveying the Pennant Village property to petitioner and Kahn. This deed was properly recorded on December 14, 1966. On December 16, 1966, petitioner and Kahn each paid $7,520.35 to the FHA, and again in January 1967, petitioner and Kahn each made additional payments to the FHA each in the amount of $7,520.35.

In May 1967, Kahn transferred his one-half interest in Pennant Village to the Title Company (which also held legal title to ECB) for the benefit of Wyman and Rich. In exchange for the one-half interest in Pennant Village, Wyman and Rich each made payments totaling $100,000 to ECB. On June 7, 1967, Kahn forwarded a check in the amount of $40,000 to the FHA in order to cure the default. Kahn also informed the FHA that he had transferred his remaining one-half interest in Pennant

Village to the Title Company for the benefit of Wyman and Rich. By letter dated June 8, 1967, to Kahn, the FHA accepted Kahn's check as performance on his guarantee and informed Kahn that they would entertain an application to transfer the Pennant Village property to petitioner. On July 14, 1967, Harry L. Johnson submitted an application for transfer of Pennant Village from the Pennant Village Corporation by Wyman, Rich, and petitioner. The FHA returned the application by letter dated August 4, 1967, and it was resubmitted by letter dated September 18, 1967. The FHA never formally approved the application for transfer of Pennant Village to petitioner.

On January 2, 1969, petitioner, Wyman, and Rich executed a deed conveying a two-thirds interest in the Pennant Village property to B.A.I., Inc., and a one-third interest in the Pennant Village property to Shelter Island Hotel Corporation.[12] On March 31, 1969, B.A.I., Inc., executed a deed conveying its interest in the Pennant Village property to Shelter Island Hotel Corporation.[13] On June 20, 1969, Shelter Island Hotel Corporation transmitted a check in the amount of $30,299.68 to the FHA to bring the Pennant Village mortgage current. By deed dated June 23, 1969, Shelter Island Hotel Corporation conveyed its interest in the Pennant Village property back to Pennant Village Corporation. This deed was recorded on June 24, 1969. On July 28, 1969, the receiver obtained the stipulated court order providing for the receiver to return possession of Pennant Village to Pennant Village Corporation.

U.S. Partnership Returns (Forms 1065) were filed on behalf of Pennant Village for the 1967 and 1968 taxable years reporting

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[12] Petitioner owned fifty percent of the stock of the Shelter Island Hotel Corporation.

[13] Thereafter Shelter Island Hotel Corporation possessed a 100 percent interest in the Pennant Village property.

losses in the respective amounts of $74,2470.20 and $55,922.31. During the years in issue, petitioner was listed as a partner on Pennant Village partnership returns.[14] Petitioner deducted his distributive share of the losses attributable to the operation of Pennant Village apartments on his 1967 and 1968 Federal income tax returns in the amounts of $37,135 and $27,961, respectively.

OPINION

The primary issue for decision is whether petitioner acquired an ownership interest in ECB, Loma Palisades, or Pennant Village, entitling him to claim deductions attributable to the respective properties.

In order to claim deductions attributable to property, petitioner must have assumed the benefits and burdens of ownership. *Houchins v. Commissioner,* 79 T.C. 570 (1982). Whether the benefits and burdens of ownership have been transferred is a factual question which requires an analysis of each transaction. *Grodt & McKay Realty, Inc. v. Commissioner,* 77 T.C. 1221, 1237 (1981). See *Tennessee Natural Gas Lines v. Commissioner,* 71 T.C. 74 (1978). Relevant factors to be considered in making this determination are: (1) Whether legal title to the property passed; (2) the manner in which the parties treat the transaction; (3) whether the purchaser acquired equity in the property; (4) whether the purchaser bears a risk of economic loss; (5) whether the purchaser exercises control over the property; and (6) whether the purchaser receives benefits from operation or disposition of the property. *Houchins v. Commissioner, supra* at 591. In the instant case, a determination of

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[14] No partnership agreements were ever executed by the partners. Respondent has conceded, however, that if petitioner is found to have acquired an ownership interest in Pennant Village, his claimed losses will not be denied because of the absence of either a valid partnership or sufficient basis.

whether petitioner assumed the benefits and burdens of ownership will require separate analysis of the facts and circumstances surrounding petitioner's involvement in each project.

Electronics Capital Building

During the years in issue, title to ECB was held by Penasquitos from March 4, 1966 through April 4, 1967. Petitioner argues that Penasquitos and the Title Company were acting as his agents in holding title to and managing ECB. Thus petitioner concludes that he, as an undisclosed principal, was entitled to claim his share of the deductions attributable to operating the building. On the other hand, respondent maintains that no agency relationship existed for tax purposes and, therefore, the losses generated by operation of ECB are properly attributable to the corporation holding title.

In support of his position, petitioner relies on the principles articulated in *Roccaforte v. Commissioner,* 77 T.C. 263 (1981), revd. 708 F.2d 986 (5th Cir. 1983), which were reaffirmed in our recent opinion of *Ourisman v. Commissioner,* 82 T.C. 171 (1984), vacated 760 F.2d 541 (4th Cir. 1985), both Court reviewed opinions. However, petitioner's reliance on these cases is misplaced. We find both *Roccaforte* and *Ourisman* to be distinguishable from the case herein.

In *Roccaforte* and *Ourisman* we carefully considered the issue of whether a corporation will be treated as a nontaxable agent for a partnership. In both cases, usury laws prevented financial institutions from lending money for construction projects to an individual or partnership. In order to obtain the necessary financing, the lender required that the nominal debtor be the corporate nominee of the partnership. Pursuant to a written agreement, the corporation held legal title to the property and executed the necessary documents to secure the financing. In *Roccaforte* and *Ourisman,* the creditors regarded the partners

as the true owners of the properties. Furthermore, once the projects were completed, the corporations did not actively manage the buildings. Rather, the partnerships managed the day-to-day activities of the buildings.

In *Roccaforte,* we decided that in *National Carbide Corp. v. Commissioner,* 336 U.S. 422, 427 (1949), the Supreme Court established the following six factors to be considered in determining whether a true corporate agency relationship exists: (1) whether the corporation operates in the name and for the account of the partnership; (2) whether the principal is bound by the corporate-agent's actions; (3) whether the corporate-agent transmitted the money received to the partnership; (4) whether receipt of income is attributable to the assets and employees of the partnership; (5) whether the corporate-agent's relationship with the partnership was dependent on the fact that it was owned and controlled by the partners; and (6) whether the corporation's activities were consistent with the normal duties of an agent.

Application of the indicia of agency specified in *National Carbide,* to the facts of the present case compels us to conclude that neither Penasquitos nor the Title Company acted as petitioner's agent in the acquisition and operation of ECB.

In support of his position that Penasquitos was acting as his agent, petitioner produced an agreement dated March 4, 1966, which provides that Penasquitos was acting as an agent for Kahn and petitioner, both undisclosed principals in acquiring ECB.[15] However, it is well established that economic substance of a transaction, rather than its form, controls for Federal tax purposes. *Gregory v. Helvering,* 293 U.S. 965 (1935); *Rice's*

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[15] We note, however, that the record shows that this agreement was actually executed on or about March 21, 1966, and was predated March 4.

Toyota World, Inc. v. Commissioner, 81 T.C. 184 (1983), affd. in part and revd. in part 752 F.2d 89 (4th Cir. 1985); *Derr v. Commissioner,* 77 T.C. 708 (1981). The establishment of a nontaxable corporate agency is not established merely by labels, semantic technicalities, or by executing such an agreement. It is not enough that the parties purport to enter an agency relationship; they must act accordingly. *Houchins v. Commissioner, supra.* We will examine the facts and circumstances surrounding the transaction to determine whether the economic realities comport with the form. See *Frank Lyon Co. v. United States,* 435 U.S. 561 (1978); *Rice's Toyota World, Inc. v. Commissioner, supra; Houchins v. Commissioner, supra.* Particularly in this area, substance over form prevails.

On March 4, 1966, Penasquitos purchased ECB from F & C. That day Penasquitos acquired legal title to the property from F & C. In exchange, Penasquitos assumed outstanding indebtedness of over $4,000,000 and executed a note to F & C in the amount of $1,047,779. From March 4, 1966 until at least April 4, 1967, Penasquitos effectively exercised total ownership and control over ECB. In our opinion, the evidence strongly suggests that Penasquitos was acting on its own behalf in the acquisition and operation of ECB and not on account for petitioner. At all relevant times, Penasquitos managed the day-to-day affairs of the corporation, maintained all bank accounts, collected all rents, and paid all bills. In all other respects Penasquitos acted as the true owner of the property.[16]

The second agency factor specified by the Supreme Court in *National Carbide* is likewise not satisfied. Petitioner, an undisclosed principal, was not bound by the actions of Penasquitos. Unlike in *Roccaforte and Ourisman,* the creditors were

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[16] See *Raphan v. United States,* 3 Cl. Ct. 457 (1983), revd. in part and affd. in part 759 F.2d 879 (Fed. Cir. 1985).

unaware that the corporation was acting on petitioner's behalf. Indeed, undoubtedly the creditors looked toward Penasquitos for satisfaction of the liabilities because Penasquitos was solvent with over $10,000,000 in assets.

The third indicia of agency is whether the corporation transmitted its receipts to the purported principal. This factor is clearly not satisfied. Penasquitos maintained the bank accounts for ECB and did not transmit any receipts to petitioner. In fact, while petitioner arranged a $250,000 loan for ECB from the State Bank and Trust Company of Wellington, the proceeds of the loan were directly deposited into Penasquitos's account and not necessarily entirely used to pay ECB debts. All rental receipts and expenses were collected by Penasquitos and deposited immediately into corporate accounts.

The fourth factor is whether income received from the project was attributable to the efforts of petitioner. At all relevant times, Penasquitos alone actively managed the ECB and hired employees to act on its behalf. Petitioner took very little active interest in the day-to-day operations of ECB. Unlike *Roccaforte* and *Ourisman* the purported agent (Penasquitos), not the principal (petitioner), was actively involved in operating and maintaining the buildings. Accordingly, we must conclude that income realized from the building was attributable to the efforts and the assets of Penasquitos.

The fifth *National Carbide* factor is that the corporate-agent's relationship with the partnership (the purported principal) must not be dependent on the fact that it was owned and controlled by the partners. In both *Roccaforte* and *Ourisman,* we concluded that this factor was only one of six indicia of agency that should be considered when determining whether a true agency relationship existed. In both cases, we found that the corporate-agent's relationship with the partners

was based, to a certain extent, upon the control which the partners, as shareholders, exercised over the corporation. Nonetheless, we held that the taxpayer established that the corporation acted as the partnership's agent. The Fifth Circuit and the Fourth Circuit reversing our respective decisions in *Roccaforte* and *Ourisman,* held that whenever such control is present, as a matter of law, the corporation cannot be found to be an agent of the partnership. In other words, the Fifth and the Fourth Circuits hold that *National Carbide's* fifth factor is mandatory and absolute.

In the instant case, respondent does not dispute that the alleged corporate agent, Penasquitos, was controlled entirely by Kahn. Moreover, during the years in issue, petitioner had absolutely no ownership interest in Penasquitos. Therefore, on the record before us, we find that the purported agent's relationship with petitioner and Kahn, the purported principals, was not based upon common ownership and control. See *Moncrief v. United States,* 730 F.2d 276 (5th Cir. 1984).

The fifth factor being satisfied, we need not decide whether to adhere to our position as set forth in *Roccaforte* and *Ourisman,* or whether to follow the Fifth and Fourth Circuits' decisions; and, we expressly decline to do so.

The sixth factor is whether the corporation's activities were consistent with the normal duties of an agent. Penasquitos's extensive involvement in the day-to-day management and operation of ECB is more an assertion of principalship than agency. Penasquitos alone assumed responsibility for the mortgage and other debts in excess of $4,000,000. Moreover, it created, by execution of its own note, a further obligation for over $1,000,000. We do not believe that an agent would, without compensation, conduct business in this manner. Quite simply, Penasquitos alone assumed the benefits and burdens of ownership.

Thus, after careful examination of the economic realities, the totality of evidence indicates that during the period March 4, 1966 through April 4, 1967, Penasquitos was not acting as an agent for petitioner. Accordingly, we hold that petitioner did not acquire the benefits and burdens of ownership and is not entitled to claim deductions attributable to the operation of ECB. We must now consider whether petitioner became on owner, for tax purposes, of ECB after April 4, 1967.

Petitioner argues that he acquired an ownership interest in ECB on April 4, 1967, when the title to ECB was transferred from Penasquitos to the Title Company. Respondent maintains that nothing occurred on that date which would give petitioner the benefits and burdens of ownership. We agree with respondent.

While the record is unclear as to exactly who, or what entity, had the benefits and burdens of ownership after April 4, 1967, for the reasons set forth below, we are certain it was not petitioner.

Several agreements were executed on April 4, 1967, none of which convinces us that petitioner suddenly acquired an ownership interest in ECB. Kahn, Wyman, and Rich executed a sales agreement in which Wyman and Rich allegedly purchased Kahn's interest in ECB for $200,000.[17] That agreement further provided that the Kahn Organization would manage ECB for 50 percent of ECB's net income. On that same day, petitioner, Kahn, and Penasquitos executed an agreement which provided that petitioner and Kahn were terminating the alleged agency relationship with Penasquitos. Shortly thereafter, title to ECB was conveyed by Penasquitos to the Title Company. Finally, sometime between April 4, 1967 and September 5, 1969, petitioner, Rich, and Wyman executed a holding agreement with

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[17] The $200,000 represented the amount Wyman and Rich advanced to Kahn sometime prior to April 4, 1967.

the Title Company which generally provided that the Title Company would hold title to ECB as their agent.

These agreements failed to establish that petitioner obtained an ownership interest in ECB after April 4, 1967. Undoubtedly the Title Company was holding title to ECB as an agent; however, it was not acting as petitioner's agent. As we stated earlier, merely executing an "agency agreement" is not enough to shift the incidence of tax; we are concerned with the economic realities and not the form employed by the parties. *Frank Lyon Co. v. Commissioner, supra; Estate of Franklin v. Commissioner,* 64 T.C. 752 (1975), affd. on other grounds 544 F.2d 1045 (9th Cir. 1976); *Houchins v. Commissioner, supra* at 589.

There was no significant change in the operation and management of ECB after April 4, 1967, which would indicate that petitioner had an ownership interest in the property. Petitioner was not involved in any management decisions regarding ECB. Moreover, the evidence suggests that the Kahn Organization and Penasquitos were acting on their own behalf in operating ECB. The Kahn Organization and Penasquitos continued to manage ECB, collecting rents, paying bills, and maintaining books and records. The ECB bank account, established by Penasquitos, did not change when the corporation assigned legal title to the holding company. Furthermore, signatory authority over the account remained vested in the offices of Penasquitos at all relevant times.

Petitioner argues that during the period April 4, 1967 through 1969, he contributed funds in excess of $1,500,000 to rescue ECB from default and continue its operation. The record, however, simply does not support such a contention. Initially, petitioner arranged a $250,000 loan in 1966 to Penasquitos which he personally guaranteed. In June 1967, petitioner arranged another personal loan to Penasquitos with the Industrial Bank of Binghamton in the amount of $60,000, which peti-

tioner also personally guaranteed. On its books and records, Penasquitos treated this as a loan from petitioner to the project. On November 8, 1967, petitioner arranged an additional loan in the amount of $100,000 secured by a deed of trust executed by petitioner, Wyman, and Rich. On December 15, 1967, ECB paid petitioner $50,000 in satisfaction of a loan to ECB. Later that month, on December 29, ECB paid petitioner an additional $45,000. These facts are as consistent with the finding that petitioner was a creditor of ECB as they are with finding that petitioner was an owner of ECB.

Quite simply, we are unable to conclude from the record that petitioner, merely through arranging various loans totaling $410,000 acquired a 50 percent ownership interest in ECB, thereby, entitling him the right to claim interest and depreciation deductions worth tens of thousands of dollars creating loss deductions to "shelter his other income." See *Davis v. Commissioner,* 66 T.C. 260 (1976), affd. 585 F.2d 807, 815 (6th Cir. 1978), cert. denied 404 U.S. 981 (1979). Accordingly, we hold that during the years in issue, petitioner did not acquire the benefits and burdens of ownership in ECB and, therefore, he is not entitled to claim loss deductions arising from operation of the building.

Loma Palisades and Pennant Village

We will first discuss petitioner's involvement with Loma Palisades and then discuss his involvement with Pennant Village.

Petitioner argues that he became the owner of Loma Palisades upon delivery and acceptance of the deeds, April 11, 1967. On the other hand, respondent maintains that ownership was not transferred to petitioner prior to July 1, 1968.[18] For the reasons set forth below, we disagree with respondent.

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[18] Apparently respondent chooses this date because it is between June 26, 1968, the date the deeds were recorded, and July 3, 1968, the date the receiver approved the transfer.

Generally, the question of when a sale is complete is a factual one. As we stated in *Houchins v. Commissioner,* 79 T.C. at 590:

> For purposes of Federal income taxation, a sale occurs upon the transfer of the benefits and burdens of ownership rather than upon the satisfaction of the technical requirements for the passage of title under State law.

Under California law, delivery and acceptance of a deed passes full legal title. Cal. Civil Code, sec. 1056 (West 1982). The failure to record a deed does not affect the validity of the deed between the parties thereto and persons who have notice thereof. *Devereaux v. Frazier Mountain Park & Fisheries Co.,* 248 Cal. App. 2d 323, 56 Cal. Rptr. 345 (1967); *Belli v. Bonavia,* 167 Cal. App. 2d 275, 334 P.2d 196 (1959). Also, the granting of a mortgage does not convey title but merely imposes a lien on the property as security for the obligation. Cal. Civil Code, sec. 2920 (West 1974). See Miller and Starr, Current Law of California, Real Estate, sec. 3:2 at 316 (1977). Moreover, if a deed of trust is executed, although legal title technically passes to the trustee, all of the incidents of ownership including the right to possession of the property and the right to transfer or further encumber the property remain with the owner. Miller and Starr, *supra* secs. 3:2 at 317 and 3:43 at 399. Finally, except for the right of possession, the appointment of a rents and profits receiver does not affect any party's title to property. See 55 Cal. Jur. 3d, Receivers, sec. 7 at 14.

Prior to the years in issue, title to the Loma Palisades property was held by the Loma corporations subject to mortgages totaling $6,292,100 which was insured by the FHA. The Loma corporations defaulted on their mortgage obligations and, on June 13, 1966, a rents and profits receiver was appointed by the court. On April 5, 1967, each Loma corporation contracted to sell to petitioner and 220, Inc. the apartment complex provided that they cure the existing delinquencies on the mortgages and take subject to the existing mortgages. On April 11, 1967, the Loma corporations executed and delivered deeds to the respective properties to petitioner and 220, Inc.; petitioner and 220,

Inc., took the properties subject to the existing mortgages. In exchange, petitioner tendered a cashier's check in the amount of $200,000 to the FHA to cure the default.

In contending that the sale was not consummated for tax purposes until July 1, 1968, respondent relies primarily on two points. First, respondent argues that the FHA did not approve the transaction until June 26, 1968, and, second, the court did not approve the transaction until July , 1968. Respondent's reliance on these factors is misplaced.

While regulatory and court approval may be necessary before clear title to Loma Palisades is passed, for tax purposes a sale is complete when there is a shift of the benefits and burdens of ownership. Moreover, the rents and profits receiver was merely a court custodian for the property and his possession does not in anyway impair or affect underlying title to the property. See Miller & Starr, Current Law of California, Receivers, secs. 22:1 and 22:3, at pp. 621, 624 (1977).

On the record before us, we agree with petitioner that for tax purposes the benefits and burdens of ownership of Loma Palisades passed to him on or about April 11, 1967. Among the facts we consider important are: (1) Petitioner obtained legal title to the property subject to the existing mortgages, by a validly executed, delivered, and accepted grant deed; (2) petitioner paid consideration for the property on April 11, 1967, by tendering a cashier's check in the amount of $200,000; (3) on August 15, 1967, the receiver paid taxes totaling $29,886.12 to the State of California on the gains reported on the transfer of the properties by the Loma corporations to petitioner and 220, Inc.; and (4) the economic risk of loss was borne by petitioner.[19] See *Houchins v. Commissioner, supra* at 591.

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[19] See *Milbrew, Inc. and Amber Laboratories v. Commissioner,* T.C. Memo. 1984-573.

Accordingly, we hold that for tax purposes petitioner assumed the benefits and burdens of ownership of Loma Palisades on or about April 11, 1967, when he accepted delivery of the deeds.

We reach a similar conclusion with respect to the Pennant Village property. Prior to the years in issue, title to the apartment complex was held by Pennant Vilage Corporation subject to a $2,000,000 mortgage insured by the FHA and secured by a deed of trust. Pennant Village Corporation defaulted on its mortgage and on February 25, 1966, a receiver was appointed. On December 12, 1966, after notice to the FHA, Pennant Village Corporation delivered a deed conveying the property to petitioner. On the record before us, we conclude that on or about December 12, 1966, petitioner assumed the benefits and burdens of ownership. We base our conclusion on the following facts: Petitioner obtained legal title, subject to the existing mortgages, to the property on that date; petitioner paid various amounts to the FHA to cure default on the existing mortgages; and petitioner assumed the risk of economic loss on the property.[20] See *Houchins v. Commissioner, supra* at 591.

We note that petitioner transferred his interest in Pennant Village on January 2, 1969. Petitioner concedes that this was a taxable event. Accordingly, we hold that petitioner is entitled to claim deductions attributable to Pennant Village only during the period December 12, 1966 through January 2, 1969.

Motion For A Supplemental Hearing

The final matter for resolution is petitioner Lillian K. Shenker's (Lillian) motion for a supplemental hearing filed with the Court April 5, 1985.

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[20] See *Milbrew, Inc. and Amber Laboratories v. Commissioner, supra.*

Seeking relief under newly amended section 6013(e),[21] the innocent spouse rule, Lillian moved this Court to hold additional hearings to present evidence concerning her lack of knowledge of the understatement of tax attributable to deductions claimed by petitioner, her husband, on their joint income tax returns filed for each year in issue. Respondent objects to the motion, arguing that petitioners' deductions are not "grossly erroneous items" as defined in section 6013(e)(2)(B) and, therefore, Lillian is not entitled to relief as a matter of law.

Even were we to assume that Lillian otherwise qualifies as an "innocent spouse" under section 6013(e), we agree with respondent that, as a matter of law, petitioners' claimed deductions are not "grossly erroneous items" as defined in section 6013(e).

Section 6013(e)(2) provides, in pertinent part:

> The term "grossly erroneous items" means, with respect to any spouse —
>
> (B) any claim of a deduction, credit, or basis by such spouse in an amount for which there is *no basis in fact or law*. [Emphasis added.]

The Committee on Ways and Means Report states that relief to an innocent spouse may be desirable in situations such as "where one spouse claims phony business deductions in order to avoid paying tax and the other spouse has no reason to know that the deductions are phony and may be unaware that there are untaxed profits from the business which the other spouse

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[21] Section 6013(e) was amended by Pub. L. No. 98-369, 98 Stat. 801, The Deficit Reduction Act of 1984, to, among other things, expand the circumstances in which an "innocent spouse" may obtain relief from tax liability. The provisions apply to all taxable years to which the Internal Revenue Code of 1954 applies, and it was intended to provide relief to an innocent spouse in "any pending court case where the decision in that case is not final." Staff of Joint Comm. on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (Pub. L. 98-369), at 720, 721 (J. Comm. Print 1984).

has squandered." Committee on Ways and Means, H. Rept. 98-432, Part 2, 98th Cong., 2d Sess., 1502. Accord, Staff of Joint Comm. on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 720, 721 (J. Comm. Print 1984)

In the instant case, petitioner's claimed deductions were not phony business deductions for which there was "no basis in fact or law." On his joint income tax returns, petitioner claimed deductions that were attributable to three properties, ECB, Loma Palisades, and Pennant Village. The deductions claimed were not frivolous or fraudulent; indeed, the expenses giving rise to the deductions were in fact incurred and were deductible under various provisions of the Internal Revenue Code. The primary legal issue before us was whether petitioner had a sufficient ownership in the respective properties entitling him to claim the deductions. Although we found that petitioner was not entitled to deduct expenses attributable to ECB, his claim to do so was not without legal basis.[22] In fact, no additions to tax were ever determined by respondent. Therefore, we hold the deductions petitioners claimed on their joint income tax returns, do not constitute "grossly erroneous items" under the statute.

Accordingly, because Lillian is not entitled to relief as a matter of law, her motion for a supplemental hearing is denied.

To reflect the foregoing and concessions by both parties,

Decision will be entered under Rule 155.

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[22] See *Neary v. Commissioner,* T.C. Memo 1985-261.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

Nos. 85-2322, 86-1176

Morris A. Shenker and Lillian K. Shenker,
Appellant,

v.

Commissioner of Internal Revenue,
Appellee.

On Appeal from the
United States Tax Court.

Submitted: June 13, 1986

Filed: October 27, 1986

Before LAY, Chief Judge, HENLEY, Senior Circuit Judge, and ARNOLD, Circuit Judge.

ARNOLD, Circuit Judge.

Lillian K. Shenker appeals from two decisions of the United States Tax Court that determined deficiencies in her joint federal income tax liability with her husband, Morris A. Shenker.[1] In both cases, the Tax Court disallowed deductions

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[1] Morris Shenker has not appealed either decision.

claimed for losses suffered in the course of Morris Shenker's business dealings; Lillian Shenker was a party to these proceedings solely by virtue of having signed joint income tax returns with her husband. Mrs. Shenker's principal argument on appeal is that the Tax Court erroneously held in each case that she was not entitled to relief from liability under the "innocent spouse" rule of §6013(e), Internal Revenue Code of 1954, as amended, 26 U.S.C. §6013(e).[2] We affirm in part and reverse in part.

I.

In the first case, the Tax Court, *inter alia,* disallowed deductions claimed on the Shenkers' 1966, 1967, 1968, and 1969 joint returns for losses suffered in the operation of a San Diego, California office building known as the Electronics Capital Building (ECB). 50 T.C.M. (CCH) 189 (1985). The court found that Mr. Shenker did not, as he contended, have any ownership interest in ECB, and therefore held that he could not claim any share of ECB's losses as a deduction.

A.

ECB has a tangled financial and ownership history. The building was completed in May 1963 by its original owner, First & C Corporation (F&C), a corporation whose stock was held by Irvin J. Kahn and three other shareholders. ECB operated at a loss, and F&C found itself in serious financial straits soon after the building's completion. Eventually, despite loans of over $1 million from its shareholders, F&C began to default on its obligations. Kahn, who had personally guaranteed payment of the $4 million primary mortgage on ECB, was called upon to maintain F&C's solvency. To resolve these financial difficulties and to facilitate finding new investors in the venture, Kahn ar-

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[2] All sections cited refer to the Internal Revenue Code of 1954, unless otherwise indicated.

ranged to have F&C transfer its interest in ECB to Penasquitos Corporation, a real estate development corporation controlled by Kahn with assets exceeding $10 million. This transfer occurred March 4, 1966. For its part, Penasquitos assumed all of F&C's outstanding indebtedness and executed a ten-year no-interest note to F&C for approximately $1 million.

Irvin Kahn was a long-time friend and client of Morris Shenker, who is an attorney, and Mr. Shenker had participated in a number of Kahn's real estate ventures. At some point in early 1966, Kahn approached Mr. Shenker concerning investment in ECB. On March 21, 1966, an agreement dated March 4, 1966, was executed in which Penasquitos agreed to act as agent for Kahn and Shenker, as undisclosed principals, in the operation and acquisition of ECB. Mr. Shenker arranged for a $250,000 loan from the State Bank and Trust Company of Wellington to Penasquitos on June 23, 1966. This loan was evidenced by a $250,000 note from Penasquitos and was secured by a first deed of trust on two parcels of land and by the personal guarantees of Kahn and Mr. Shenker. From March 4, 1966 through April 4, 1967, Penasquitos alone actively managed ECB; Penasquitos established bank accounts in its name doing business as ECB, kept ECB's books and records, and managed ECB's day-to-day operations. Mr. Shenker was not involved in any decisions concerning ECB operations.

On April 4, 1967, Mr. Shenker, Kahn, and Penasquitos executed a new agreement providing that Mr. Shenker and Kahn terminated Penasquitos's agent status, agreed to hold Penasquitos harmless from all claims connected to its operation of ECB, and assumed all liabilities and obligations incurred by Penasquitos in operating ECB. That same day, Sidney Wyman and Charles Rich entered an agreement with Kahn under which each acquired a 25 per cent interest in ECB from Kahn in exchange for $200,000 previously advanced to Kahn. This agreement also authorized another entity controlled by Kahn, the Kahn Organization, to act as Wyman's and Rich's agent in operating and managing ECB, in return for a fee of 50 per cent.

of ECB's net income. After April 1967, Wyman and Rich paid this fee to the Kahn Organization, but it appears that Penasquitos continued to play some role in ECB's operation.

Also in April 1967, Penasquitos conveyed legal title to ECB to the Title Insurance and Trust Company of San Diego (Title Company). While the precise date is unclear, at some point between April 4, 1967 and September 5, 1969, Mr. Shenker, Wyman, and Rich executed an agreement with the Title Company providing that the Title Company would hold title to ECB as an agent for them.

In June 1967, Mr. Shenker arranged for a $60,000 loan from the Industrial Bank of Binghamton to Penasquitos for ECB. Mr. Shenker personally guaranteed this loan, which was treated on ECB's books as a loan from Mr. Shenker. The Industrial Bank of Binghamton billed Mr. Shenker for interest due on the loan, but ECB paid these bills. On November 8, 1967, a $100,000 loan was obtained from Thrift Credit Corporation. This obligation was secured by a deed of trust executed by Mr. Shenker, Wyman, and Rich, and by the original deed of trust to the Title Company. On December 15, 1967, ECB borrowed $100,000 from Wyman. That same day, ECB paid Mr. Shenker $50,000; on December 29, 1967, ECB paid him an additional $45,000.

In 1966, 1967, 1968, and 1969, ECB filed partnership returns reporting losses ranging from about $115,000 to about $362,000. Each year, Mr. Shenker was listed as a partner, along with Kahn and/or Wyman and Rich. Mr. Shenker claimed a distributive share of 50 per cent. of these losses on the returns he filed jointly with Mrs. Shenker during the years in issue. The Commissioner of Internal Revenue disallowed the deductions on the ground that they were allocable to Penasquitos or the Title Company. Mr. and Mrs. Shenker challenged his ruling in the Tax Court, arguing that Penasquitos and the Title Company were merely acting as Mr. Shenker's agents in holding title to and managing ECB.

Examining the facts and circumstances presented above with an eye towards economic substance rather than form, the Tax Court concluded that Mr. Shenker had never assumed the benefits and burdens of ownership of ECB, and that neither Penasquitos nor the Title Company had acted as his agent in the acquisition and operation of ECB. 50 T.C.M. at 194-197. Analyzing Mr. Shenker's relationship with Penasquitos by reference to factors identified by the Supreme Court in *National Carbide Corp. v. Commissioner,* 336 U.S. 422, 437 (1949), for use in determining whether a corporation had acted as an agent or on its own behalf, the Tax Court found that Penasquitos had acted on its own behalf, and that it alone assumed the benefits and burdens of ownership. The Court further found that nothing occurred at the time of or after the transfer of title to ECB from Penasquitos to the Title Company that gave Mr. Shenker an ownership interest in ECB. The Court summed up its view of the evidence by stating: "Quite simply, we are unable to conclude from the record that [Mr. Shenker], merely through arranging various loans totaling $410,000 acquired a 50 percent ownership interest in ECB." 50 T.C.M. at 197. The Court went on to deny Mrs. Shenker's motion for a supplemental hearing to establish her right to relief under §6013(e)'s innocent-spouse rule on the ground that the ECB deductions were not "grossly erroneous items" as required by §6013(e)(2)(B).

B.

Lillian Shenker argues first, that the Tax Court erred in applying the factors enumerated in *National Carbide* to her husband's relationship with Penasquitos, and second, that if this was not error, the ECB deductions were grossly erroneous and she is entitled to an opportunity to establish the remaining requirements for relief under §6013(e). We disagree with both arguments.

1.

Mrs. Shenker correctly observes that the Supreme Court in *National Carbide* addressed the question under what cir-

cumstances one who owns or controls a corporation may successfully argue that the corporation has acted as his agent, rather than on its own behalf in conducting a transaction, thereby avoiding taxation of the corporation on the income from the transaction. 336 U.S. at 424; see also *Moline Properties, Inc. v. Commissioner,* 319 U.S. 436, 438-439 (1943). Here, in contrast, there is no contention that Mr. Shenker owned any part of Penasquitos. Concern that taxpayers may make use of the corporate form's advantages while avoiding its tax disadvantages, see *Moline,* 319 U.S. at 438-439, are therefore of limited relevance to this case.[3]

While *National Carbide* is thus not perfectly analogous to the case before us, the Supreme Court in that case nonetheless elaborated factors that are, with one exception, of general applicability in determining whether a corporation has acted as another's agent or for its own benefit. The factors identified in *National Carbide* were: (1) whether the corporation operates in the name and for the account of the principal; (2) whether the principal is bound by the corporate agent's actions; (3) whether the corporate agent transmitted the money received to the principal; (4) whether receipt of income is attributable to the assets and employees of the principal; (5) whether the corporate agent's relationship with the principal was dependent on the fact that it was owned and controlled by the principal; and (6) whether the corporation's activities were consistent with the normal duties of an agent. 336 U.S. at 437.

Of these, only the fifth factor is not relevant to determining whether a corporation has acted as the agent of a non-owner principal such as Mr. Shenker. Further, the Tax Court without hesitation resolved this factor in Mr. Shenker's favor, finding that since Mr. Shenker had no ownership interest in Penas-

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[3] The present dispute would be more nearly analogous to *National Carbide* if Kahn's tax liability, rather than Mr. Shenker's, were at issue. Kahn, unlike Mr. Shenker, was a shareholder in Penasquitos.

quitos it was not possible that his relationship with Penasquitos was based on common ownership or control. 50 T.C.M. at 196. On the other hand, under the Tax Court's analysis of the remaining five factors, each indicated that Penasquitos had acted on its own behalf, rather than as Mr. Shenker's agent.[4] *Id.* at 195-196. We conclude that it was not error for the Tax Court to appraise the Shenker-Penasquitos relationship by reference to these factors, or to conclude based on its findings in this regard that Penasquitos, rather than Mr. Shenker, owned ECB.

2.

However, while we affirm the Tax Court's conclusion that Mr. Shenker was not an owner of ECB, we cannot agree with Mrs. Shenker's alternative argument that his claim of ownership was so baseless as to afforded her the possibility of relief under the innocent-spouse rule of §6013(e).

Section 6013(d) (3) provides that spouse who choose to file joint income tax returns are jointly and severally liable for any tax due on their aggregate income. Section 6013(e) establishes an exception to this rule for cases in which (1) a joint return contains a substantial understatement of tax attributable to "grossly erroneous items" of one spouse; (2) the other spouse did not

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[4] The Tax Court found as to the first factor that Penasquitos always operated in its own name in conducting ECB business, and maintained all ECB accounts in its own name. 50 T.C.M. at 195. As to the second factor, the Court found that Mr. Shenker, who was at most an undisclosed principal, was not bound by Penasquitos's actions, and that ECB's creditors undoubtedly looked to Penasquitos's $10 million in assets as the guarantee for ECB's liabilities. *Id.* With regard to the third factor, the Court found that Penasquitos transmitted no receipts to Mr. Shenker, placing them instead in its own ECB accounts. *Id.* at 195-196. On the fourth factor, the Court found that because Penasquitos alone actively managed ECB, ECB income was not attributable to Mr. Shenker's efforts, assets, or employees. *Id.* at 196. Finally, in applying the sixth factor, the Court concluded that Penasquitos's extensive involvement in ECB's operation and its assumption of responsibility for ECB's considerable debts were assertions of principalship rather than agency. *Id.*

know or have reason to know of the understatement, and (3) it is inequitable to hold the innocent spouse liable for the resulting deficiency.[5] The Tax Court rejected Mrs. Shenker's attempt to invoke §6013(e) on the ground that the ECB deductions were not grossly erroneous items, and consequently found it unnecessary to address the remaining requirements for §6013(e) relief. 50 T.C.M. at 199.

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[5] Section 6013(e)(1) currently states:

> In general. — Under regulations prescribed by the Secretary, if —
>
> (A) a joint return has been made under this section for a taxable year,
> (B) on such return there is a substantial understatement of tax attributable to grossly erroneous items of one spouse,
> (C) the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such substantial understatement, and
> (D) taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such substantial understatement,
>
> then the other spouse shall be relived of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such substantial understatement.

Section 6013(e)(4) establishes a further requirement: the understatement must exceed a specified percentage of the innocent spouse's adjusted gross income (10 per cent. if the income is $20,000 or less, and 25 per cent. if the income is over $20,000).

Until §6013(e) was amended by §424 of the Deficit Reduction Act of 1984 (the Act), Pub. L. No. 98-369, 98 Stat. 494 (1984), it provided protection only where there had been an understatement of gross income, and not where, as in the present case, a deduction had been improperly claimed. As amended, §6013(e) extends to any kind of "understatement of tax" meeting the other criteria; §424(c) of the Act renders this amendment retroactively applicable to all traxable years governed by the Internal Revenue Code of 1954 in any case still pending at its enactment, bringing the present case within its purvey.

We concur in the Tax Court's assessment. A "grossly erroneous" deduction is one "for which there is no basis in fact or law." §6013(e)(2). While Mr. Shenker did not prevail on his claim that he owned a portion of ECB, his claim of ownership was not entirely groundless. Facts supporting Mr. Shenker's claim include the existence of the March 21, 1966 "agency agreement" between Penasquitos, Kahn, and Mr. Shenker, the April 4, 1967 agreement between the same parties, and the agency agreement between the Title Company and Wyman, Rich, and Mr. Shenker. His claim was further supported by his efforts at obtaining loans for ECB and his personal guarantees that the loans obtained would be repaid.

We therefore affirm the Tax Court's rejection of Mrs. Shenker's request for §6013(e) relief as to the ECB deductions.[6]

II.

In the second case, the Tax Court disallowed a deduction claimed on the Shenkers' 1971 joint return for the loss of securities held on Mr. Shenker's account at a brokerage firm that he was unable to recover when the firm went bankrupt in 1972. 48 T.C.M. (CCH) 164 (1984). The Tax Court found that under §165 of the Code Mr. Shenker was not entitled to claim

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[6] Mrs. Shenker, citing *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982), argues in both cases before us today that the United States Tax Court cannot properly adjudicate her tax liability because it is not constituted under Article III of the Constitution. Courts before and after *Northern Pipeline* have uniformly upheld the constitutionality of the Tax Court, *e.g.*, *Knoblauch v. Commissioner*, 749 F.2d 200, 202 (5th Cir. 1984), *cert. denied*, 106 S. Ct. 95 (1985); *Sparrow v. Commissioner*, 748 F.2d 914, 915 (4th Cir. 1984); *Redhouse v. Commissioner*, 728 F.2d 1249, 1253 & n.2 (9th Cir.), *cert. denied*, 105 S. Ct. 506 (1984); *Ginter v. Southern*, 611 F.2d 1226, 1229 & n.2 (8th Cir. 1979), *cert. denied*, 446 U.S. 967 (1980); *Stix Friedman & Co., Inc. v. Coyle*, 467 F.2d 474 (8th Cir.) (per curiam), *aff'g* 340 F. Supp. 4 (E.D. Mo. 1972), and we see no substance in Mrs. Shenker's argument that *Northern Pipeline* calls the constitutionality of the Tax Court into question.

the deduction in 1971 because the loss was suffered in 1972 rather than 1971.

A.

The securities in question were held on Mr. Shenker's account with White & Company, a St. Louis, Missouri brokerage firm in which Mr. Shenker was a shareholder. In November 1970, Mr. Shenker executed an agreement subordinating his claims to the stock held on his account to the claims of present and future White & Company creditors arising before November 1971, and providing that he would not withdraw his stock from the account before November 1971. The purpose of this agreement was to meet the Securities and Exchange Commission's (SEC) and the New York Stock Exchange's capital requirements. In April 1971, Mr. Shenker executed a second such agreement with White & Company. This second agreement, which was to expire in April 1972, was to enable White & Company to meet the capital requirements of the Midwest Stock Exchange and the SEC. Mr. Shenker entered these agreements because White & Company was experiencing financial difficulties, and he wished to prevent its bankruptcy.

White & Company's efforts in 1971 and early 1972 to use Mr. Shenker's subordination agreements and those of others to meet SEC requirements were unsuccessful. Instead, in March 1972, the Securities investor Protection Corporation commenced a proceeding for liquidation of White & Company, applying for and obtaining an order adjudicating that the firm's customers needed protection under the Securities Investor Protection Act of 1970 (SIPA), 15 U.S.C. §78aaa *et seq.*

SIPA affords two sorts of protection to customers of brokerage houses: First, it guarantees payment of the customer's claims up to $50,000 and second, it provides for return to the customer of his "specifically identifiable property" held by the house at liquidation. In June 1972, Mr.

Shenker filed under SIPA for the return of 19 different issues of stock held on his White & Company accounts. Before June 1972, he had made no formal demand on White & Company for return of these stocks, though he had discussed getting the stock back with an employee of White & Company in 1971. The trustee in the liquidation opposed Mr. Shenker's claims, and they were ultimately rejected by this Court in 1976 when we held that the subordination agreements precluded granting Mr. Shenker SIPA's protections. *SEC v. White & Co., Inc.*, 546 F.2d 789 (8th Cir. 1976).

On their joint return for 1971, Mr. and Mrs. Shenker claimed an ordinary loss with respect to the stock in the White & Company account, excluding from the amount claimed $50,000 that Mr. Shenker expected to recover under SIPA. The Tax Court, emphasizing that White & Company remained a viable company until forced into liquidation in March 1972, and that Mr. Shenker never formally demanded return of the stock until June 1972, concluded that no identifiable event had occurred in 1971 upon which Mr. Shenker sustained a loss with respect to the stock. 48 T.C.M. at 166-167. The Tax Court also concluded that, by virtue of his SIPA claims, Mr. Shenker had a reasonable prospect of recovery of the stock in 1971. *Id.* at 167. It therefore concluded that under §165(a) he had suffered no loss that he was entitled to claim on his 1971 return. *Id.* Finally, in a supplemental order, the Tax Court denied Mrs. Shenker's request for innocent-spouse relief under §6013(e), holding that since the loss had in fact occurred at some point, the issue was merely one of timing, and the claim was not "grossly erroneous."

B.

Mrs. Shenker's sole argument as to this case is that the Tax Court erred in denying her §6013(e) innocent-spouse relief on the ground that deduction was not "grossly erroneous." We agree with her position.

Section 165(a) permits deductions only for losses "sustained during the taxable year." Therefore, for there to be some "basis in fact or law," §6013(e)(2), for a deduction under §165(a), there must be some basis not only for claiming that a loss occurred, but also for claiming that it was sustained during the taxable year in question. In the present case, the findings of the Tax Court discussed above make clear that there was simply no basis upon which Mr. Shenker could claim that the loss of his stock occurred in 1971, rather than some later year. We therefore reverse the decision of the Tax Court on this issue, and remand the case for consideration of whether Mrs. Shenker meets the remaining requirements for relief under §6013(e).

III.

We conclude that the Tax Court's application of the *National Carbide* factors in determining whether Penasquitos acted as Mr. Shenker's agent in operating ECB was proper. We also concur in its conclusion that there was sufficient basis for Mr. Shenker's ECB deductions to bar §6013(e) relief for Mrs. Shenker as to those deductions. However, we hold that the Tax Court erred in concluding that the 1971 stock-loss deductions were not grossly erroneous. Accordingly, the decision of the Tax Court as to the ECB deductions is affirmed, but its decision as to §6013(e) relief for the stock loss deductions is reversed, and that case is remanded for further proceedings consistent with this opinion.

A true copy.

Attest:

Clerk, U.S. Court of Appeals, Eighth Circuit.